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J E I

R E P O R T

A Two-Part Report: A and B

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Japan's Trade Surplus Drops Again

Amid the ups and downs of the exchange rate -- and the bilateral political rhetoric -- one factor in Japan's trade picture has changed little in recent years: its trade surplus keeps falling. Despite the year-and-a-half-old downward trend in the yen's value, Japan's overall trade surplus declined another 18 percent on a dollar-denominated year-to-year basis in the April-June period (see Tables). The drop was the fifth straight year-to-year quarterly decline. The slide was even steeper -- 22.8 percent -- comparing the surplus in the first half of 1990 to the same period in 1989. Furthermore, the decline was broad based. During the second quarter the surplus with the United States fell a sharp 25.7 percent in dollar terms from the April-June 1989 quarter. The worldwide and bilateral yen-denominated surplus also showed drops.

Do the figures mean that Japan's trade surplus is likely to be a thing of the past before long? Of course not. Even if the decline should continue at the same dollar amount as the annualized rate for 1990's first half, five years would be required to eradicate the surplus, which topped \$64 billion in 1989. Moreover, experts disagree widely as to whether this rate of decline will be maintained.

Japan's Total Trade in Dollar Terms

(in millions of dollars)

	<u>Exports</u> (f.o.b.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> (c.i.f.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1985	\$175,638	3.2%	\$129,539	-5.1%	\$46,099
1986	209,151	19.1	126,408	-2.4	82,743
1987	229,221	9.6	149,515	18.3	79,706
1988	264,917	15.6	187,354	25.3	77,563
1989	275,175	3.9	210,847	12.5	64,328
1988: I	60,279	17.1	44,505	39.2	15,774
II	65,179	14.5	47,260	29.9	17,919
III	67,169	16.1	47,258	23.2	19,911
IV	72,291	14.8	48,331	12.9	23,960
1989: I	68,227	13.2	51,142	14.9	17,085
II	67,602	3.7	51,292	8.5	16,310
III	69,595	3.6	53,048	12.3	16,547
IV	69,751	-3.5	55,364	14.6	14,387
1990: I	66,718	-2.2	54,302	6.2	12,416
II (p)	67,221	-0.6	53,848	5.0	13,373

Japan's Total Trade in Yen Terms

(in billions of yen)

	<u>Exports</u> (f.o.b.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> (c.i.f.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1985	¥41,956	4.0%	¥31,085	-3.8%	¥10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1987	33,315	-5.6	21,737	0.9	11,578
1988	33,939	1.9	24,006	10.4	9,933
1989	37,823	11.4	28,979	20.7	8,844
1988: I	7,713	-3.1	5,688	14.7	2,025
II	8,163	0.1	5,918	13.6	2,246
III	8,924	4.9	6,280	11.3	2,644
IV	9,139	5.1	6,121	3.3	3,018
1989: I	8,705	12.9	6,516	14.6	2,189
II	9,222	13.0	6,997	18.2	2,225
III	9,911	11.0	7,547	20.2	2,363
IV	9,985	9.3	7,919	29.4	2,067
1990: I	9,767	12.2	7,929	21.7	1,838
II (p)	10,447	13.3	8,375	19.7	2,072

Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

	<u>Exports</u> <u>(f.o.b.)</u>	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> <u>(c.i.f.)</u>	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1985	\$65,278	8.9%	\$25,793	-4.0%	\$39,485
1986	80,456	23.3	29,054	12.6	51,401
1987	83,580	3.9	31,491	8.4	52,090
1988	89,634	7.2	42,037	33.5	47,597
1989	93,189	4.0	48,246	14.8	44,943
1988: I	19,859	10.3	10,090	44.4	9,769
II	21,610	2.0	10,458	37.8	11,152
III	23,056	6.6	10,667	29.3	12,389
IV	25,109	10.3	10,821	25.0	14,288
1989: I	22,726	14.4	11,599	15.0	11,127
II	22,997	6.4	12,064	15.4	10,933
III	24,117	4.6	12,462	16.8	11,655
IV	23,347	-7.0	12,120	12.0	11,227
1990: I	21,664	-4.7	12,728	9.7	8,936
II (p)	20,950	-8.9	12,827	6.3	8,123

Japan's Trade with the United States in Yen Terms

(in billions of yen)

	<u>Exports</u> <u>(f.o.b.)</u>	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> <u>(c.i.f.)</u>	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1985	¥15,583	9.6%	¥6,213	-2.4%	¥9,369
1986	13,564	-13.0	4,918	-20.9	8,646
1987	12,148	-10.4	4,582	-6.8	7,566
1988	11,487	-5.4	5,388	17.6	6,099
1989	12,816	11.6	6,632	23.1	6,184
1988: I	2,541	-8.8	1,290	19.1	1,251
II	2,706	-10.8	1,309	20.5	1,397
III	3,063	-3.6	1,418	16.7	1,645
IV	3,177	0.9	1,371	14.4	1,806
1989: I	2,899	14.1	1,478	14.6	1,421
II	3,139	16.0	1,648	25.9	1,491
III	3,436	12.2	1,773	25.0	1,663
IV	3,342	5.2	1,733	26.4	1,609
1990: I	3,170	9.4	1,859	25.8	1,311
II (p)	3,256	3.7	1,995	21.1	1,261

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The pessimists, who believe that Japan's surplus is likely to prove intractable, have two main arguments. First, the current figures are somewhat distorted by the yen being weaker in this year's first six months than in January-June 1989. Adjusting for the price changes resulting from this and other factors, Japan's trade balance was virtually unchanged between the two periods. For example, using 1989 prices and yearly percentage changes in volume, Japan's real trade imbalance declined a scant 0.4 percent on a year-to-year basis in the second quarter. Second, the weak yen is unlikely to be even a mixed blessing for long. Eventually, Japanese exports will respond strongly to the exchange rate, lifting the surplus in dollar terms. This effect may be evident already, obscured by the use of year-to-year data. On a seasonally adjusted month-to-month basis, the trade imbalance in dollar terms grew in May and June.

Optimists argue that the yen's unprecedented rise between 1985 and November 1988 has not yet played itself out. Specifically, they believe that foreign direct investment by Japanese firms, motivated in part by the currency realignment during that period, has differing short- and long-run effects. The short-run impact, which has been dominant up to now, leads to higher exports from Japan in the form of capital goods to equip the foreign plants and to more parts for final assembly abroad. Together, these effects more than offset what is initially a small decline in finished goods exports. Over time, however, local content rises, reducing parts exports compared to earlier levels even if new investment remains at the same rate. In addition, final goods exports are likely to fall further, and modest shipments from the overseas plants to Japan may lift imports. Over time, this argument concludes, the net effect of foreign investment is to reduce the trade surplus.

An Economic Planning Agency study released in mid-July appears to boost the optimists' argument. EPA assumed that, if recent levels of overseas investment flows, domestic content rates and reexport percentages to Japan remain unchanged, then Japan's surplus would be \$18.5 billion smaller five years from now than what it would be in the absence of such an investment flow. Simulations conducted by private organizations have found even larger effects of foreign investment on the trade surplus. EPA cautions that the actual direction of the imbalance will depend on a number of factors that are difficult to forecast. The exchange rate obviously heads this list. Changing export and import patterns arising from foreign investment are likely to affect the value of the Japanese currency. For example, if the effect of foreign investment should be to reduce net exports, then the yen could weaken, producing offsetting effects on the trade surplus. At most, EPA's exercise demonstrates one set of plausible circumstances under which a continued substantial reduction of Japan's still-large trade surplus could occur.

Douglas Ostrom

Japan Remains Top Creditor

Japan has added another economic trophy to its collection, but the latest one is a bit tarnished. For the fifth straight year Japan's overall foreign assets exceeded its offshore liabilities in 1989 by a greater margin than in any other nation, making it the world's largest creditor at yearend. However, the rate of increase in net assets came to a measly 0.5 percent (see

Table 1). Most of the creditor position is accounted for by the private sector, which was a net debtor as recently as 1981.

Table 1: Japan's Net External Assets, 1972-89

(in millions of dollars)

<u>End of Year</u>	<u>Private Sector</u>	<u>Government Sector</u>	<u>Total</u>
1972	\$-6,820	\$20,687	\$13,867
1973	-3,021	16,037	13,016
1974	-8,318	17,261	8,943
1975	-10,302	17,320	7,018
1976	-11,653	21,227	9,574
1977	-6,182	28,162	21,980
1978	-2,550	38,764	36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821
1986	138,541	41,810	180,351
1987	146,494	94,250	240,744
1988	147,571	144,175	291,746
1989	158,839	134,376	293,215

Source: Bank of Japan, Balance of Payments Monthly, April 1990.

Washington takes a particularly dim view of statistics on net creditor positions, and not just because this country's position is the mirror image of Japan's: the world's largest debtor by most accounts. The Commerce Department stopped publishing the total figures this year, substituting explanations as to how the components of such totals are flawed. For example, America's mammoth foreign direct investment, which, even according to official figures, is well over twice that of Japan's, is understated because it is valued at historical cost rather than current market value. (Commerce promises a new, improved data series next year.) However, several independent analysts have concluded that, while the size of America's debtor position is overstated, the decline in its position in recent years is approximately correct. If one disregards Commerce's objections and uses its data, the United States owed foreigners \$663.7 billion more in 1989 than was owed to this country, up from \$531.1 billion in 1988.

Japan's data reveals several interesting patterns. For example, private and government asset holders switched roles in 1989. Between 1987 and 1988 net official assets increased sharply, offsetting sluggish rates of growth in private overseas investment. But in 1989 overall net assets rose despite a sharp decline in official assets. The turnabout probably reflected a change in Bank of Japan intervention in foreign currency markets. In 1988, when the yen still was appreciating in value, the Bank of Japan substituted for private Japanese

buyers of U.S. and other foreign government securities, adding to its foreign exchange reserves and thereby putting a prop under the dollar. Last year, however, the yen and the dollar reversed roles; it was the Japanese currency that needed help. As a result, BOJ reduced its foreign exchange reserves substantially, reflected in part in the decline in short-term government assets (see Table 2).

Table 2: Japan's External Assets and Liabilities, 1988 and 1989

(in millions of dollars)

	Assets		Liabilities	
	End of 1988	End of 1989	End of 1988	End of 1989
Long-Term	\$832,669	\$1,019,218	\$311,625	\$447,472
Private Sector	728,168	901,736	268,431	405,498
Direct Investments	110,780	154,367	10,416	9,160
Trade Credits	48,791	52,866	23	16
Loans	123,663	137,084	1,061	18,895
Securities	427,218	533,781	254,886	373,990
Others	17,716	23,638	2,045	3,437
Government Sector	104,501	117,482	43,194	41,974
Loans	55,570	60,471	26	7
Others	48,931	57,011	43,168	41,967
Short-Term	636,678	751,785	865,976	1,030,316
Private Sector	538,802	666,712	850,968	1,004,111
Monetary Movements	502,256	627,846	765,165	894,679
Others	36,546	38,866	85,803	109,432
Government Sector	97,876	85,073	15,008	26,205
Monetary Movements	97,869	85,072	5,144	16,957
Others	7	1	9,864	9,248
Total	1,469,347	1,771,003	1,177,601	1,477,788

Source: Bank of Japan, Balance of Payments Monthly, April 1990.

The composition of private assets also changed in 1989. The net position in securities actually declined, falling from \$172.3 billion to \$159.8 billion or 7.3 percent. However, direct investment abroad soared by nearly 40 percent over the 1988 level to \$154.4 billion. This figure is understated to the extent that overseas investments financed abroad may not be reflected. In addition, Japan's 1989 balance of payments figures included an unusually large \$22 billion errors and omissions entry that may represent, in part, unreported out-bound capital flows that presumably are not reflected in the tables. (Errors and omissions came to \$2.8 billion in 1988.) This large number could distort figures in the tables as well as the net change in Japan's asset position. Thus, most analysts use this set of Japanese statistics -- like their U.S. equivalent -- with considerable caution.

Douglas Ostrom